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November 20, 2014

Thomas H. Mattox
Commissioner
NYS Department of Taxation and Finance
W. A. Harriman Campus, Building 9
Albany, NY 12227

Re: <u>Guidance Under the New York State Corporate Tax Reform Provisions</u>[1]

Dear Commissioner Mattox:

The Tax Section of the New York State Bar Association (the "Tax Section") is pleased to submit the recommendations set forth below for guidance relating to certain changes in corporate tax law effected as part of Governor Cuomo's 2014 budget legislation, S6359-D/A8559-D (the "Act").

Background

The Act contained comprehensive provisions intended to simplify and rationalize New York's taxation of corporate income. The Act combined the previously separate taxes on banks and general business corporations and made major changes respecting taxable nexus, the apportionment of income and capital, combined reporting rules, and the treatment of net operating losses, among other provisions.

The Tax Section prepared a report, dated September 5, 2014 (the "September Report"), discussing technical corrections to the legislation. In this letter, we address guidance that we recommend be issued by the Department of Taxation and Finance (the "Department") with respect to the new statutory provisions.

[1] The principal drafters of this letter were Peter L. Faber and Lindsay M. LaCava. Helpful comments were received from Joshua E. Gewolb, Maria T. Jones, Samantha Kopf, Steven B. Land, Arthur R. Rosen, and Eric Sloan. This letter reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

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Many of the provisions will take effect on January 1, 2015, and there is a need for early guidance with respect to the Department's administration of these provisions because corporations will have to establish systems and record-keeping procedures to enable them to comply with the new law.

Some of our recommendations could appropriately be dealt with by regulations, but we recognize that the procedures for drafting and adopting regulations can take some time. Accordingly, we recommend that the Department issue less formal guidance, such as technical service memoranda, and indicate that taxpayers can rely on such guidance even though less formal pronouncements may not technically be binding on the Department. This guidance could be incorporated into regulations later.

Investment Income/Expense Attribution

Section 208.6(b) provides that, instead of subtracting from investment income the interest deductions that are attributable to investment income, the taxpayer may elect to reduce its total investment income by 40%. The provision was intended to provide a mechanism to avoid disputes over the attribution of expenses to investment and business income. The law does not indicate when the election should be made and whether it is revocable. Absent any statement to the contrary, it would be possible for the election to be made or revoked at any time, subject only to applicable statutes of limitations. We believe that this flexibility would be consistent with the provision's purpose. It is possible that later adjustments, through carrybacks or audit adjustments to entire net income, might change the desirability of making the election, and we believe that a taxpayer should be allowed to make or revoke the election under these circumstances. While in theory one could provide that the election is revocable only under specified circumstances, it would be hard to anticipate all the circumstances under which revocation might be desirable, and there would seem to be no harm in allowing it to be revocable at any time within the applicable statute of limitations. The September Report recommended that the statute be amended to clarify these points, but we believe that the Department has the power to address these issues in regulations.

Apportionment

Digital Products

Under the hierarchy of sourcing methods for digital products in section 210-A.4(C), the first method requires a taxpayer to source receipts to the customer's "primary use location." The second method requires a taxpayer to source receipts to the location where the digital product is "received." These rules give rise to a number of questions for which guidance would be helpful.

With respect to the first method (primary use location), the word "primary" indicates that this is an all-or-nothing sourcing rule in situations in which a customer has multiple points of use. If that is correct, how does one measure the degree of use in various locations so as to determine the "primary" use location (e.g., in the case of a corporate customer, is the use location based on the location and number of the employees accessing the product, the location of each individual use of the digital product, or something else)? How is a customer's "use location" determined? Is a digital product "used" at the location where the customer accesses or downloads the digital product or service? One problem that could come up with respect to this issue is that the taxpayer may not be able to determine who at the customer uses a product or where the use occurs. It would be desirable to base the determination on facts that are in the taxpayer's records, such as the customer's billing address.

Similarly, with respect to the second sourcing method (location where "received"), since digital products are, by definition, delivered electronically, how is the location where the product is "received" by the customer determined? Is it the location where the customer accesses or downloads the digital product? If so, how is this sourcing method different from the primary use location method? What if a customer accesses a digital product from multiple locations (e.g., a corporation purchases a digital product that is received by several employees in different locations)? Are the receipts allocated among several locations and, if so, how should they be allocated (e.g., based on number of employees, number of downloads)?

The statute also provides that a taxpayer in applying the hierarchy of sourcing methods "must exercise due diligence under each method . . . before rejecting it and proceeding to the next method in the hierarchy, and must base its determination on information known to the taxpayer or information that would be known to the taxpayer upon reasonable inquiry." This requirement also raises several questions and concerns for which guidance would be helpful.

What constitutes a "reasonable inquiry"? Can a taxpayer make a reasonable inquiry based on a review of its own books and records and the customer contract and invoice? Can a taxpayer rely on representations from its customer as is permitted in the sales tax area? Is a taxpayer required to ask its customers for information regarding their primary use location and/or location of receipt? If so, how many times must the information be requested if a customer does not respond? Can a taxpayer rely on IP address location information in determining a customer's primary use location and/or location of receipt? Can a customer's billing address be used as a proxy for use location and/or location received absent any other available information?

These questions can be illustrated by an example. A law firm purchases a research service for all of its attorneys. The service is negotiated and purchased by the law firm's library in State X, but the research service is used by the law firm's attorneys throughout the country. How should the research service provider determine the law firm's "primary use" location? Can it be determined based on the location of the offices to which the attorneys with access to the research service are assigned? Does the research service provider have to determine the location of each attorney each time he or she uses the research services (which would seem overly burdensome)? In determining where the services are "received," can the receipts be sourced to the location of the law firm's library that initially purchased the service, or does the research provider have to look at the location of each attorney who uses the service? Does the research provider need to track this information independently (e.g., track the IP address location information for each attorney who accesses the service) or can it rely on representations by the law firm about where the service is being used or received?

Whatever test is used, we believe that a taxpayer should be allowed to rely on representations by a customer without further inquiry. A taxpayer who relies on good faith on a sales tax exemption certificate provided by a buyer is protected in assuming that the sale is not taxable without further inquiry. The same principle should apply here.

Other Services and Other Business Receipts

Under the hierarchy of sourcing methods for other services and other business receipts in section 210-A.10(B), the first sourcing method requires a taxpayer to source receipts to New York if the "benefit is received in the state." The second sourcing method requires a taxpayer to source receipts to the "delivery destination." These rules also give rise to a number of questions for which guidance would be helpful.

With respect to the first method under the hierarchy (location where the benefit is received), how is that location determined? California has similar statutory language and has adopted a detailed regulation establishing hierarchies for determining where the benefit is received.[2] What if a service is used in multiple locations? Is there an all-or-nothing rule or can receipts be sourced to multiple locations to the extent that the benefit is received in multiple locations?

With respect to the delivery destination, a number of states have adopted a sourcing rule based on the location of delivery but have adopted varying approaches to determining the delivery location.

Similar to the digital products rule, the statute also provides that a taxpayer in applying the hierarchy of sourcing methods, "must exercise due diligence under each method . . . before rejecting it and proceeding to the next method in the hierarchy, and must base its determination on information known to the taxpayer or information that would be known to the taxpayer upon reasonable inquiry." This also raises several issues.

What constitutes a "reasonable inquiry"? Can a taxpayer make a reasonable inquiry based on a review of its own books and records and the customer contract and invoice? Can a taxpayer rely on representations from its customer? Is a taxpayer required to ask its customers for information regarding their primary use location and/or location of receipt? If so, how many times must the information be requested if a customer does not respond? Can a customer's billing address be used as a proxy for use location and/or location received absent any other available information?

The third sourcing method for both digital products and other services and other business receipts is the "apportionment fraction for such receipts within this state determined pursuant to this subdivision for the preceding taxable year." How does this provision operate for the 2015 tax year? Do taxpayers skip this level of the hierarchy and proceed to the fourth method since no receipts were sourced "pursuant to this subdivision for the preceding taxable year" or can taxpayers use the "old" rules?

In this part of the report we have pointed out areas that should be clarified. We have suggested different approaches. We do not have a strong preference among the options suggested. The key point is that rules should be adopted that will be clear and administrable by taxpayers and by Department auditors.

Combined Reporting

Since the unitary business requirement is now central to the determination of a combined group, it might be helpful to expand upon the definition of a unitary business in regulations. For example, how is the unitary business test applied if a corporation that is not includible in the combined report (e.g., an insurance corporation taxable under Article 33) provides the unitary "link" among a group of corporations? We recommend that a unitary business should be held to exist under these circumstances. The Department might want to consider establishing a list of factors that if present will lead to a

[2] Cal. Code Regs. Title 18, section 25136-2 (c)(1).

rebuttable presumption that the companies are engaged in a unitary business to help minimize audit and litigation activity on this issue.

Economic Nexus

The economic nexus provisions seem to be based on the facts in each taxable year. Some taxpayers may meet the requirements in some years and not in others. We believe that the statutory language indicates that a corporation that meets the requirements in one year and not in the next does not have nexus in the second year. Guidance should clarify this point.

We appreciate your consideration of our recommendations.

Respectfully submitted,

David H. Schnabel
Chair

cc: Nonie Manion
Executive Deputy Commissioner

Amanda Hiller
Deputy Commissioner and Counsel